TITLE I
INCOME TAX

EXPLANATION

Brief Overview

Title I imposes a tax on the taxable income of individuals and legal entities from sources within Progresa, and, in addition, in the case of resident taxpayers of Progresa, investment and financial income from all sources. The rate of tax on individuals is zero % for the first PR 50,000, 15% for the taxable income between PR 50,000 and PR 100,000, and 30% of the taxable income over PR 100,000. The rate of tax on entity (corporate) taxable income is 30%. The tax on entity taxable income is reduced by credit for a 30% withholding tax on dividends distributed to shareholders. The effect of the credit is to avoid double taxation of distributed entity income in most cases.

The 30% tax rate applies to all taxable income of the entity. Although a graduated series of tax rates is appropriate in the individual income tax applicable to physical persons, it is not appropriate for entities. The purpose of rate graduation is to provide progressivity, to provide a lower rate of tax on lower incomes. That purpose is not satisfied in the case of the taxation of an entity, since the profits of the entity are really those of the owners. A lower tax rate for income of an entity is appropriate only when the income attributable to a shareholder, when added to his other income, is low enough to justify that lower rate. However entities (whether big or small, whether with many owners or few, and whether having large or small profits) are likely to have as the bulk of their direct or indirect owners, individuals whose income is taxable at the highest rate. Moreover taxing entities at graduated rates leads to all kinds of attempts to split businesses into separate entities to multiply the amount of income subject to lower rates through use of several entities.

Rate brackets for individuals will be adjusted to reflect inflation. An inflation adjustment also applies to the net equity interest of businesses as well as to investment assets.

Gross income is broadly defined to include income from all sources, except for certain fringe benefits. Those fringe benefits, however, are subject to a special 30% tax (on the grossed up amount— the value of the fringe benefits plus the tax) collected from the provider of the benefit. Taxable income is determined by subtracting from gross income the allowable deductions, principally business expenses.

Broad administrative authority is granted to insure compliance, including withholding by payors. The explanation that follows clarifies the principles of the statutory draft and is intended to assist in the preparation of regulations that will implement Title I when enacted.

Explanation of Particular Sections

The Code is intended to be a permanent framework for the revenue laws of Progresa. Thus, it is drafted with gaps in the sequential numbering of sections. This will simplify the making of amendments in the future by the insertion of new sections without the necessity of general renumbering of cross references within the Code (and the renumbering of the regulations and the references therein).

Chapter 1. General Provisions

Sec. 1. Tax Imposed.

Section 1 imposes a tax on the taxable income of all persons, that is, natural persons, entities, and estates. Section 12 defines entities and those organizations that are treated as "pass-throughs" and not subject to entity taxation. Each country will have to adopt a definition of entity compatible with its own legal system. Because the entity tax rate and the top marginal tax rate applicable to physical persons are identical (30%) under the BWTC, the BWTC leans to making as many enterprises as possible taxable as entities. In that way the tax can be collected from one taxpayer, whereas if taxation were on a pass through basis to the owners, there might be multiple taxpayers with increased difficulty of administration.

Sec. 2. Income Subject to Tax.

Section 2 provides that resident taxpayers are taxed upon their income from sources within Progresa and their investment and financial income from all sources. Nonresident taxpayers are taxable only upon taxable income from sources within Progresa. The source of income is determined under rules contained in chapter 10. The limitation of taxation of nonresident persons to income from Progresa sources accords with international norms. In the case of resident taxpayers the Code opts for an exclusion of foreign source income (other than investment and financial income). The alternative would be to include worldwide income of a resident taxpayer from all sources and to allow a foreign tax credit to avoid double taxation of income with a source outside Progresa. We decided to avoid the complication of the foreign tax credit mechanism in such situations. Source rules themselves involve complication, but such complication is not eliminated under a foreign tax credit system, since it is involved in determining foreign source income for applying a foreign tax credit. In most emerging economies resident taxpayers are not likely to have significant foreign source income from operations.

It is necessary to include investment and financial income in the base, even if foreign source, to discourage the flight of investment capital abroad, particularly to countries like the United States having an exemption for income of foreign investors in bank deposits and portfolio debt.

Investment or financial income includes income from, and gains from the sale of, stocks, bonds, evidences of indebtedness, publicly traded instruments, net leases of property, investment in real property if the taxpayer does not engage in substantial management activity, bank accounts, and the like. Thus, for a Progresa resident individual or entity taxable as a resident corporation, interest on foreign bank accounts is taxable. Section 12(c)(3) treats the permanent establishment in Progresa of a nonresident person as a separate entity. Since this entity would be a resident entity, financial or investment income directly attributable to the permanent establishment is taxable, but financial or investment income derived outside Progresa by the nonresident person is not taxable if such income is not specifically attributable to the conduct of activities in Progresa.

Sec. 3. Amount of Tax.

Section 3 sets forth the individual and entity rates described in the brief overview above. As indicated in the introduction the draft proposes a rate schedule for individuals that does not tax the first PR 50,000 of taxable income. This will eliminate from income taxation approximately 80% of the individuals having taxable income. Since such 80% is apt to spend most of their income on personal consumption, indirect taxation will impose an appropriate burden on them. For those with interest from small savings accounts in resident financial institutions, there is a 5% schedular final withholding tax on such interest. See Section 163. Thus, even if there is an income tax collected by withholding, a taxpayer whose income consists solely of wages subject to withholding, plus only interest on a savings account, will not need to file a return, and the withheld taxes are the final accounting for liability. There is no need to burden persons whose incomes are at subsistence level, or not much higher, with income tax reports and filings. Nor should the tax administration be involved in auditing or processing a large number of tax returns for them.

There may be payroll taxes on wage earnings to finance social benefits, frequently imposed solely on the employer. The economic burden of such taxes on labor is, of course, largely borne by employees. In designing a social insurance system, it may be better to have the burden shared by employer and employee with benefits geared to wages paid to, and accounted for by, employees individually. This is a subject for the next edition. Nevertheless, as discussed in the introduction, some countries may wish to impose the regular income tax on physical persons on a wider population of workers. In such a case it is important that the tax be withheld by the employer as a final tax on as broad a number of workers as possible. In that case, the zero bracket amount or any personal credit would be reflected in withholding tables. Thus, as stated in the previous paragraph, the income tax would reach large numbers of taxpayers without their having to file income tax returns. See Section 171(k).

The top individual rate and the single entity rate are deliberately identical to minimize tax incentives to influence the form of operation and economic activity. Also, the threshold at which the top individual rate is reached is relatively low for the same reason. Those small businesses that are incorporated with income subject to the flat 30% corporate tax can effectively insure the benefit of the lower individual brackets on the first PR 100,000 of income by making salary payments to the officer-shareholders that will be deductible from the gross income of the entity, reducing its tax by 30% of the payment includible in the income of the individual.

In spite of the low threshold for the top marginal rate, there is substantial progressivity in the effective tax rate for individuals — the actual tax liability as a percentage of economic income. This is because of the zero rate on the first PR 50,000 and the breadth of the tax base (which includes gains realized at death).

For example, the effective rates of taxation taking into account the amount exempt by virtue of the zero bracket are:

(1) Total Income	(2) Tax	(3) Percentage Effective Rate (2) ÷ (1)
PR 50,000	0	0%
PR 60,000	1,500	2.5%
PR 75,000	3,750	5%
PR 100,000	7,500	7.5%
PR 150,000	22,500	15%
PR 200,000	37,500	18.75%
PR 500,000	127,500	25.5%
PR 1,000,000	277,500	27.75%

The relatively generous band consisting of the first PR 50,000 of taxable income is intended to be a substitute for all personal allowances for the taxpayer, including allowances for dependents, old age, disability, war service, and the like. The proliferation of personal allowances can cause a serious erosion of the tax base, the need to draw difficult and arbitrary lines, and a vast expenditure of administrative effort to police the lines.

Nevertheless, there will be some countries that wish to grant allowances for some of these categories, particularly for dependents. At this point consideration should be given to converting the zero bracket amount and any additional personal allowances to direct credits against tax liability. An exemption or deduction of PR 10,000 yields a tax saving of PR 1,500 to the taxpayer in the 15% bracket and a tax saving of PR 3,000 to a taxpayer in the 30% bracket. By substituting a credit against tax of PR 1,500 (the tax on PR 10,000 for the 15% taxpayer) for an exemption or a deduction, the tax saving becomes the same for taxpayers regardless of their top marginal rate.

Sec. 4. Credits.

Section 4 allows the credits against tax provided by chapter 14. Chapter 14 provides credit for —

(1) Withholding on wages, interest (other than interest paid to resident individuals by Progresa financial institutions), royalties, gambling winnings, and transfers of real property,

(2) advance payments of income tax, and

(3) foreign taxes on certain investment and financial income.

Sec. 5. Treatment of Estates.

Section 5 provides that for the calendar year that includes death, a deceased individual and that individual's estate are to be treated as one taxpayer. The income and deductions of the estate are combined with the income and deductions of the individual and taxed under section 3(a). Similarly, the estate is to be treated for the next calendar year as an individual subject to the rate schedule contained in section 3(a). Thereafter, in order to prevent continuing use of an estate as a separate entity to secure an extra run up the bracket scale, an undivided estate is taxed at the rate applicable to an entity (30%). The period provided for continuing an estate under the rate structure for individuals could be extended beyond the one year we have provided in the BWTC, if warranted by the normal period to wind up the administration of the estate in the particular jurisdiction. Distributions of income and principal from an estate are not taxed to the recipient. See Section 13(c)(2).

Chapter 2. Definitions of General Application

Sec. 11. Definitions Apply to All of Code.

Section 11 provides that the definitions of sections 12 through 19 apply throughout the Code unless otherwise specified. Other sections define certain terminology at the point it is used.

Sec. 12. Taxpayer Related Definitions.

Section 12(a) defines "person" to include any entity or individual. It also includes an estate treated as an individual under section 5(a).

Section 12(b) defines "taxpayer" as meaning any person subject to any tax under the Code.

Section 12(c) defines as an "entity" (and subject to the 30% rate on entities) any person treated as a juridical entity under the laws of Progresa. The term includes corporations, cooperatives, and any business activity other than one carried on by an individual or by a pass-through. Although a government or charitable organization is not subject to the tax as such, the term "entity" includes a business activity carried on by a government or a nonprofit organization. Such a business activity will be taxable under section 1 by reason of section 92. A governmental business activity excludes the performance of traditional non-commercial functions such as defense, police protection, revenue collection, education, public recreation, and the like, but includes commercial activities such as operating an airline or shipping line, selling electricity, and other activities where the enterprise derives revenue from charges to paying customers or users for goods or services furnished.

It should not be permissible to use the entity as a tax avoidance device. For example, suppose the owner of an entity performs significant services in managing the business of the entity, but chooses not to take any compensation. Instead he takes distributions of entity income as dividends that are excluded from income under Section 13(c)(7). In that way he hopes to avoid the payroll tax on employers for social contributions. The tax administration may recharacterize the portion of the amount paid as dividends that represents compensation and treat it as subject to the payroll tax. (It would also be treated as salary paid, deductible to the entity and taxable compensation to the recipient).

Section 12(d) defines "individual" as a physical person.

Section 12(e) contains a definition of "permanent establishment" that is intended to be broader than those in general use in tax treaties. For this reason, countries may prefer to substitute a different label, such as "economic presence," to reflect more accurately the economic link or connection being described. A country may wish to shorten the period required in most tax treaties for a building or construction site to constitute a permanent establishment. It might also say that registration of an entity to do business in a country, or that establishing a sales link through modern communication techniques, is sufficient to create a "permanent establishment." The very low threshold by which a foreign investor becomes a permanent establishment could then be raised for investors of treaty partners in negotiations in exchange for other concessions sought by the country.

Section 12(f) defines "pass-through." A pass-through is defined as a partnership or other organization having 10 or fewer owners all of whom are individuals or estates. In addition there must be reasonable proportionality in the sharing of items of capital, income, and loss so that there will not be undue shifting of income and losses among the owners. The term "pass-through" does not include an entity. Thus, a corporation, cooperative, or permanent establishment is not a pass-through. See, however, the discussion in the commentary on Section 164 as to the possibility of extending pass-through treatment to entities with closely held ownership (relatively few shareholders).

As with a proprietorship, the pass-through is not taxed separately for purposes of the income tax. Instead, the owners are taxed on their proportionate shares of the income. Partnerships or other unincorporated associations that fail to meet either the ownership or the proportionality requirements will be taxed as entities and their distributions to the partners or other owners will be treated as dividends. Regulations may provide that a pass-through that meets both the ownership and proportionality tests will still be treated as an entity for administrative purposes and determination of the taxable income that flows through the pass-through to the owners, including for purposes of review and audit.

Section 12(g) defines "proprietorship" as a business enterprise with only one individual owner. For this purpose a husband and wife under a regime of community property are to be treated as one individual.

Section 12(h) defines "resident individual" as one who has a principal place of abode in Progresa or is physically present in Progresa for more than 182 days during the calendar year.

The principal place of abode of an individual is determined by factual considerations that indicate primacy — amount of time spent, nature of time spent, where the individual's family resides, and the like. And the presence test is determined by counting as one day on which any part is spent in the country.

Each country should look at these tests carefully. In some cases it may be desirable to make exceptions for workers living in a neighboring country who commute daily to their jobs in Progresa. It may be thought inappropriate to subject them as resident individuals to tax on investment and financial income derived from the countries in which they live. Similarly, an exception may be appropriate for skilled foreign workers (such as engineers) who have been hired for a period up to perhaps five years to conclude specific projects in Progresa. Also, Progresa may have entered into international agreements under which foreign nationals working for foreign embassies or for international organizations are not to be taxed as resident individuals.

Section 12(i) defines "resident entity" as an entity organized under the laws of Progresa. The term also includes a permanent establishment, but only with respect to the income derived from Progresa sources.

Some countries may wish to expand the definition of "resident entity" so it also includes any entity managed in Progresa or having its principal place of business in Progresa. Under such an expanded definition the regulations could provide that an entity is managed in Progresa if a majority of its directors are residents of Progresa or if its principal executive officers conduct the entity's affairs from Progresa. The principal place of business of an entity for this purpose would be the country in which more of its business activities are conducted than in any other country.

We chose to avoid the administrative complexity of making the factual determinations necessary to apply an expanded definition. The Progresa source income will be taxed even if it is not a resident entity, and a resident entity desirous of avoiding resident status could probably restructure itself to place itself outside of the expanded definition.

Section 12(j) defines "nonresident" as an entity or individual that is not a resident entity or resident individual.

Section 12(k) defines "foreign" as referring to income derived from sources outside of Progresa.

Section 12(l)(1) contains a general definition for "related person." In general, the intent here is to treat as one unit natural persons and legal entities that have such close ties that they can be expected either to act as one economic unit or to enter into transactions with each other on more favorable terms than they would extend to unrelated persons. Section 12(l)(1) defines this related group as including the members of the taxpayer's family, plus entities and pass-throughs that are tied to the taxpayer's family through at least 50% ownership by either vote or value.

While there is a need for a "related person" concept in the Code (for example, for purpose of denying losses on so-called "sales" between related persons), each country will have to determine what relationships best fit in with the social and economic patterns of that country. In some countries brothers and sisters are likely to act as a single economic unit. In other countries, and for certain specified purposes, the 50% threshold may be either too high or too low.

Sec. 13. Definitions Related to Income or Deductions.

Section 13(a) defines "gross income" to include all income from whatever source derived. To make it clear that the term includes gains (such as gains from the sale of property) the definition specifically mentions gains as being included.

Gross income may differ from gross receipts. For example, gross income from the sale of inventory is gross proceeds of sale, less cost of goods sold.

Gross income is an all inclusive definition that includes but is not limited to items specified in Section 13(b) such as compensation for services, earnings from business, gains from the sale or other disposition of property, rents, royalties, pensions, gambling winnings, and interest other than interest subject to a special final tax under Section 163.

We have avoided the approach of stating that gross income is the aggregate of several categories of income computed separately. For example we have seen laws that separately compute income from business, income from services (wages and salaries), income from property investments, etc. and then aggregate them to determine total income. We would avoid this approach since it is rarely possible to compartmentalize kinds of income without gaps and overlaps between the categories and confusion as to allocation of deductions.

Gross income does not include the occupancy value of owned real estate and the items specifically excluded by Section 13(c) and other sections. For instance, it does not include:

(1) mandatory employer contributions to pension and welfare funds (Section 13(c)(1)),

(2) gifts and inheritances, and distributions from estates (Section 13(c)(2)),

(3) proceeds of life insurance payable on the death of the insured (Section 13(c)(3))(but it does include gain from the surrender of a policy),

(4) benefits received from health or disability insurance (Section 13(c)(5)),

(5) fringe benefits taxable under Section 161 (Section 13(c)(6)),

(6) dividends excludable under Section 164(e) and stock dividends excludable under Section 102(b) (Section 13(e)(7)), and

(7) interest taxable under Section 163.

Section 13(c) also specifically mentions as excludable indemnification for work accidents, certain gain from the sale of principal residence, income of foreign diplomats, and child support.

If the payment of alimony or similar amounts to former spouses is customary, the country may wish to make express provision for its treatment. For instance, it could include the alimony under Section 13(b) as income to the recipient and allow the payor spouse a deduction. Alternately, it could treat alimony in the same way as the Code treats child support — the alimony would not be income to the payee and would not be allowed as a deduction to the payor.

We have excluded from income contributions to social security pensions, but have not excluded the receipt of such pensions from income. For almost all recipients of such pensions, the zero bracket amount will enable the recipients of such pensions to escape taxation. Those that have other income that, when combined with the pension, results in income at a taxable level should pay tax. The income from pensions is deferred compensation for past employment. It may be received by rich and poor alike, and exemption merely gives a valuable subsidy to the rich in the form of tax saving. While there may be political difficulty with taxing social security pensions, it is best to face it at the outset. It will be much harder to impose taxation at a later date upon a form of income that has enjoyed exemption.

Section 13(d) defines "includible income" as meaning gross income after taking out the items that the Code expressly excludes and by also taking out those items that are excluded because they are derived from sources outside of Progresa. Sections 141 and 142 and the regulations thereunder set forth rules as to the source of income. For example, income from real property situated in Progresa or from carrying on a business in Progresa, including the performance of services there, is from sources in Progresa. In the case of a Progresa business, the salary of an employee who is sent abroad on short business trips would also be treated as Progresa income.

Section 13(e) defines "taxable income" as includible income less deductions.

Section 13(f) defines "deductions" as the deductions allowable to the taxpayer under Title I of the Code (principally under chapter 3). Section 144(b) provides that deductions are to be allocated to the income (Progresa or foreign) in the production of which the deduction was incurred. Thus, in computing taxable income the taxpayer's includible income will be reduced by only those deductions that are sourced in Progresa under Section 144(b).

Sec. 14. Dividend and Shareholder.

Section 14(a) defines "dividends" to include any distribution to the holder of an equity interest in an entity (as defined in Section 12(c) no matter what legal status the entity may have for general and commercial law purposes) with respect to such equity interest, other than a distribution in complete liquidation. The holder of an equity interest is likewise treated as a shareholder for income tax purposes, even if not for commercial law purposes. Thus, a distribution to the equity holder is subject to the withholding tax under Section 164(a), unless it is part of a complete liquidation under Section 103(b). The distribution of property other than money is treated as a dividend equal to the grossed up fair market value of the property distributed. (See, however, special rules as to stock dividends in Section 102). If a country wishes to impose a separate tax on dividends, the problem of when a permanent establishment makes a distribution is presented, since legally there is one entity. Our suggestion in that case is the use of a branch profits tax on all profits, distributed or not. This is discussed below in connection with the commentary on Section 164.

Sec. 15. Business.

Section 15 provides that "business" includes any trade. It also includes any rental activity and any other activity entered into for profit where the taxpayer materially participates in the management of the activity on a regular, continuous, and substantial basis.

Sec. 16. Investment Activity.

Section 16 defines "investment activity" as any activity entered into for profit where the taxpayer's management activity is less than that required to make the activity a business with respect to that taxpayer. The distinction between business activities and investment activities is an important one. In the case of an investment activity, Section 40(b) provides that a separate charitable deduction will not be allowed, and Section 53 (a) provides that losses from sale of investment securities are allowed only to the extent of gains from such sales.

Sec. 17. Executive Power.

Section 17 defines the term "Executive Power" to mean the President of Progresa. If the form of government of a country vests the executive power in a prime minister, a council, or other person or body, appropriate changes in the Code should be made.

Sec. 18. Tax Administrator.

Section 18 defines "Tax Administrator" to mean the head of the Tax Service created by Section 501.

Sec. 19. Designated Officer.

Section 19 defines the term "designated officer" as the officer of the Tax Service designated in accordance with law to carry out the particular function referred to.

Chapter 3. Deductions.

Chapter 3 deals with the deductions allowable against includible income to arrive at taxable income. It also deals with items not allowed as deductions (see Section 32) as well as certain other items that are not immediately deductible in full (including those that must be spread over several taxable years, such as depreciation and depletion).

Sec. 31. Business Expenses.

Section 31(a) allows the deduction from includible income of the expenses of carrying on a business. Some countries today have elaborate lists, prepared on an industry-by-industry basis, of the only expenses that may be deducted. We believe that this detailed approach is a mistake for the following reasons:

(1) it often does not achieve its goal of curtailing deductions because of the ingenuity of taxpayers in labeling expenses so as to fit into permitted categories,

(2) it begins to break down when the taxpayer is engaged in two or more different lines of activity,

(3) to prepare a complete list of all expenses that may be incurred to produce profits in all lines of activity is a physical impossibility, particularly when we move beyond the production of physical goods to distribution, marketing, and service industries, and

(4) any list, even if it were complete when prepared, would become out of date because of innovations in lines of business and ways of carrying them out.

For these reasons Section 31(a) relies on the general test of whether an expense was paid (in the case of a cash basis taxpayer) or incurred (in the case of an accrual basis taxpayer) to carry on a business. The general test implies a reasonable relationship to the business, but we do not intend that the revenue administration substitute its judgment for the good faith judgment of business management as to the desirability of incurring the expense for purposes of business profit. The general test is coupled with the other provisions of chapter 3, such as the prohibition in Section 32 against deducting certain items. For example, Section 32(c) makes it clear that personal, living, and family expenses may not be deducted. The tax administration may disallow deductions for compensation paid to family members who actually perform few or no services, or for the purchase of an automobile that is primarily used for personal convenience of the owner.

In addition, Section 517 gives the Tax Administrator authority to require adequate books and records including substantiation (such as receipts) for business expenses. Also Section 32(h) provides for the disallowance of deductions not substantiated by adequate proof of the amount of the expense and its business purpose.

Examples of business expenses are compensation to employees, including owners, for services actually performed, rentals, travel expenses, and the like. Business expenses will also in many cases include the cost of material used in producing goods. However in the case of businesses selling goods, Section 13(a) contemplates that gross income is determined after reducing gross receipts by the cost of goods sold. Inventory accounting, based on the difference between the inventory at the beginning of the tax year increased by additions during the tax year and the inventory at the close of the tax year, is required to determine the cost of goods sold. See chapter 5. Costs properly included in inventory are not allowable as business expenses, but are used to determine inventory values.

An employee's employment is his or her trade or business. Section 31(b) limits business expenses of a worker whose business is the performance of services as an employee of another to those prescribed by regulations. An employee's expenses are not deductible if they are not essential to the fulfillment of the obligations as an employee. Thus, uniforms not usable as ordinary dress may be deductible, but regular clothing is not. Expenses for the benefit of the employer, not required as a condition of employment, are not necessary to the employee's business as an employee. For example, an employee may not deduct use of an office in the home to do work for the employer where an office of the employer is available. Employee business expenses below a threshold amount of PR 1000 are not deductible at all, to prevent difficult problems of auditing small amounts.

Section 31(b) also provides that the deduction of the business expense of self-employed individuals is to be governed by regulations. A threshold of PR 1000 similar to that for employees applies to the business expenses of self-employed individuals.

Section 31(c) deals with expenses that have mixed personal and business elements. To be deductible as a business expense the business element must be more than 50%, and then only the business portion is deductible.

Thus, if a taxpayer incurs transportation expenses to travel to a location for a week's vacation and makes a side trip of two days to call on a client, no part of the transportation expenses involved in getting to and from the holiday location would be deductible. The expenses exclusively attributable to the side trip would be deductible, if they otherwise satisfied the conditions of the law for deductibility of business expenses.

Section 32(b) denies a deduction for expenses relating to an activity generally considered to be entertainment, amusement, or recreation. Although such expenditures do have a relation to developing customers or other relationships beneficial to carrying on a business, they also have in most cases a large element of personal purpose that is administratively difficult to assess separately.

Experience has shown that the tax system is unable to stand the strain of differentiating between the business and personal aspects of such expenses. Examples of many well off persons charging off as business expenses their personal high living in expensive restaurants, and luxury facilities, discredit the appearance of fairness of the income tax and undermine taxpayer morale and compliance generally. Since a large part of such expenditures have an attenuated connection to the business, their disallowance is justified to protect the integrity of the tax system.

It should be noted that the disallowance provision of Section 32(b) does not apply where the entertainment, etc., is part of the taxpayer's business. Thus, a restaurant owner may deduct 100% of the cost of selling meals to customers who are entertaining their guests, but the customers may not deduct the cost of the meals for themselves and their guests even if they try to show that they may be legitimate business expenses and not personal expenses.

Section 31 contains no special provision allowing an immediate deduction in full for research and experimental expenses. The Preliminary Edition of the Basic World Tax Code contained such a provision. However, we believe that this tax incentive is not a proper one. The difficulties of drawing the line as to what constitutes a research or experimental expense are great, and any such provision promises to become a revenue drain and administrative headache without leading to significant research that would not otherwise have been carried on. For that reason, under this Code research and experimental expenses will have to be capitalized and taken into account only as the asset cost is amortized (if amortization is allowed) or upon disposition of the asset.

Deductions for activities not carried on primarily for profit, that are essentially hobbies of the taxpayer, are not allowable in excess of income from that activity. For example, a taxpayer who engages in an activity of breeding race horses with no reasonable expectation of profit may not deduct net losses from that activity.

Section 32. Items Not Deductible.

Section 32 contains very important limitations (in addition to Section 32(b) discussed above) on the kinds of expenses that may be deducted as business expenses under Section 31.

Section 32(a) precludes the deduction of capital expenditures except where otherwise provided in the Code. As used here, the term "capital expenditures" means amounts paid or incurred by the taxpayer for items that will have a useful life beyond the tax year in which the expense occurs. In many cases although the capital expenditures are not immediately deductible they can be recovered over time by deduction. See, for example the depreciation deduction for tangible property under Section 34 and the amortization of intangible property under Section 34(j). Of course capitalization provides a basis that is recovered without tax upon the sale of the capitalized asset.

We would leave to regulations the question of requiring the capitalization of many items that taxpayers might claim as business expenses or investment expense. Examples are interest to carry land for speculative gain, interest to acquire inventory, interest to acquire depreciable property, and the like. Although a theoretical case can be made to require capitalization of interest in the cost an asset, ease of administration may suggest that this theory be applied only to prevent abuse in the case of large expenditures.

Section 32(c) provides the general rule that personal, family, and living expenses are not deductible. This includes interest on consumer loans such as loans to acquire an automobile or a residence. Nor would taxes on such items be deductible. Insurance premiums for personal protection are not deductible. Losses on the sale or destruction of tangible property not used for business (such as an automobile or a home) are not deductible.

Section 32(d) provides that the income tax, and other taxes under Title I (other than the fringe benefit tax) are not deductible. Withholding taxes are current taxes of the person withheld upon. Hence a withholding tax on wages is deductible by the employer as compensation paid. Excise taxes, property taxes, and other similar taxes may be deducted as business expenses in appropriate cases. If they are costs of acquiring property, they must be capitalized and added to the cost of the property.

Section 32(e) provides that payments to a family member, to an officer or director of a corporation, or to any other related person are not deductible unless they are reasonable compensation for services actually rendered, reasonable interest for a genuine loan, reasonable rental for property actually used in the business, or otherwise proper business expenses. Payments that do not meet the requirements of a business expense will be treated as dividends and subject to withholding under Section 164.

Section 32(f) disallows losses on sales between related persons such as family members or an owner and his or her controlled entity. In such a case a loss has not been realized since the same economic interests still control the property purported to be sold.

Section 32(g) disallows expenses to produce tax exempt income. For example, the cost of collecting items referred to in Section 13(c) would not be deductible to the extent the items are non-taxable. The expenses of earning interest subject to the reduced rate of tax under Section 163 and the expenses allocable to non-taxable foreign source income are also not deductible.

Section 32(h) requires substantiation of any expense as a condition of its deductibility. The substantiation includes the actual fact of the expense, the amount, and the business or investment relationship.

Sec. 33. Interest.

Section 33 permits the deduction of interest paid only if it is related to carrying on a business. Although business interest is not deductible under Section 31(a) but only under Section 33, it is deductible under Section 33 only if it would otherwise have qualified under Section 31(a) (that is, it must be an expense of a business). Personal interest is not deductible. Interest connected with investment activities is currently deductible only to the extent allowed by Section 40.

While business interest is currently deductible in full in the case of a Progresa for-profit enterprise, subsections (b) and (c) of Section 33 place a limitation on the current deduction of interest by entities more than half of the equity interests in which are owned by nonresident taxpayers or by tax-exempt organizations. For this purpose a permanent establishment of a nonresident taxpayer will of course be treated as meeting the 50 percent nonresident ownership test.

For those enterprises subject to the 50% limit, business interest is currently deductible first up to the amount of business interest income and then up to 50% of net non-interest income. Net non-interest income is business income aside from business interest income and business interest expense for the taxable year. Interest disallowed because of the 50% limitation may be carried forward to the next year and treated as if it was incurred in the next year.

The 50 percent limit of Section 33 prevents stripping earnings on disguised equity from an entity owned by nonresidents or non-profits. That is, it prevents the elimination of entity tax by capitalizing the entity with excessive shareholder debt. The debt concerned is not only debt advanced by a lender who is a related party. The limit also applies to interest on borrowings from unrelated banks, for example. It would be impossible to police all the various arrangements that foreign owners might make with foreign lending institutions involving reciprocal conduct that would be difficult to trace.

The allowance of interest in full against business interest income protects banks and other financial intermediaries in the business of lending borrowed funds. The 50% limit is applied by aggregating all business activities of a particular taxpayer that are subject to Progresa taxation. A taxpayer whose residence is subject to a mortgage may not claim that the mortgage loan is a business loan and that interest thereon is business interest.

The operation of subsections (b) and (c) of Section 33 may be illustrated as follows: a permanent establishment has gross income of PR 2,000,000, including PR 100,000 of business interest income, business interest expense of PR 500,000 and other business deductions of PR 1,400,000. Only PR 350,000 of the 500,000 is currently deductible (PR 100,000 against business interest income and PR 250,000 against PR 500,000 of net business income aside from business income and expense). The other PR 150,000 will be treated as an interest expense of the next year and added to actual interest expense of the next year, subject to the same limitation equal to business interest income plus 50% of net non interest income (taxable business income without interest income or interest expense).

The percentage of income test is much easier to apply than a required equity ratio in characterizing debt. Balance sheets usually reflect historical costs, rather than current values. Hence a true equity ratio is difficult to determine. The administrative simplicity of the 50% deduction limit was considered to be worth accepting the occasional hardship of interest disallowance in a start up situation that is not attributable to excessive use of debt financing, but rather to low initial earnings. This is especially true since the limit applies only to entities controlled by foreign owners or not for profit organizations.

Sec. 34. Depreciation.

Sec. 35. Pooled Asset Accounts.

Sec. 36. Repairs and Improvements.

Sections 34, 35, and 36 prescribe the method of depreciation accounting and allowance of depreciation deductions. The cost of each tangible asset is to be assigned to the appropriate category listed in Section 34(d). The annual percentage allowance for each category is prescribed under Section 34(f). Category 1 includes buildings and their structural components. Each building, including its structural components, is separately accounted for in determining depreciation. Later improvements to a building are added to the account for that building (pro rated for the first year to take into account only that portion of the year during which the improvements were in service). A rate of 5% applies to the declining balance of the capital account without regard to salvage. A country might consider allowing a deduction of the remaining balance in the capital account representing a single building when the declining balance reaches some minimum amount (or percentage of original cost) to avoid maintaining the account in perpetuity.

Category 2 is automotive equipment, office furniture, and information and data handling equipment. A percentage rate of 25% applies to the balance of the capital account for category 2. Category 3 property is all other depreciable tangible assets, and a 15% rate applies to the balance in the capital account.

Category 2 and Category 3 property is accounted for under a pooled method. The cost of all assets falling into a particular category is added to the pooled account for such category regardless of differing taxable years when they were placed in service. The product of multiplying the applicable depreciation rate times the balance is deductible, and the balance carried to the beginning of the next year is reduced by that deductible amount. Proceeds received from the disposition of assets in any pool during any year reduce the balance in that pool (if below zero, the negative balance becomes gross income). The cost of purchases of assets assigned to a pool during any year is credited to the balance in the pool one-half in the year of purchase and one-half the next year as discussed in the next paragraph.

The cost of newly acquired assets is to be added to the capital account under Section 34(g) under the half year convention described in Section 35(b). Under that convention one half of the cost is added for the year when the asset is placed in service and the other one half for the year following. Thus, the capital account at the end of the year of placing in service will include one half of the cost of a new asset no matter in what month it is placed in service. Similarly, under Section 35(c) a half year convention applies when an asset is disposed of. One half of the reduction in the capital account is recognized in the year of disposition and one half in the next year.

Under Section 36 amounts expended for repairs and improvements that do not exceed 5% of the opening balance for the year of the capital account are currently deductible, but the excess of such amounts expended over 5% is to be added to the capital account balance.

The pooled account treatment may be illustrated as follows: A business has Category 3 assets that at the beginning of the fiscal year (year 1) have a cost or remaining undepreciated fiscal cost of PR 300,000. Category 3 assets exclude buildings and automotive equipment, furniture, and information processing equipment. Otherwise, all tangible depreciable property is aggregated. Assume no inflation adjustment. During year 1 a machine in class 3 is sold for PR 25,000 and in August a new machine is purchased for PR 60,000. PR 20,000 is spent to repair and improve existing equipment in Category 3.

The deduction for depreciation of Category 3 assets for year 1 is 15% times the pooled account balance at the end of year 1. That balance is determined by reducing the opening balance by PR 12,500, one half of the amount realized from sale of property. The effect is to increase income equal to one half the proceeds of sale by reducing future depreciation deductions. Proceeds of sale reduce the balance to PR 287,500. Half of the cost of new acquisitions is added to the balance (PR 30,000). The addition for new assets increases the balance to PR 317,500. Repairs and improvements are currently deductible up to 5% of the opening balance before adjustments for additions and dispositions (5% x PR 300,000 = PR 15,000), so the remaining PR 5,000 is treated as a new purchase. PR 2,500 (one-half of the new purchase of PR 5,000) increases the balance to PR 320,000.

The depreciation deduction for year 1 for Category 3 assets is thus 15% x PR 320,000 = PR 48,000. The opening balance for the beginning of the next year (year 2) is reduced by the depreciation allowed at the close of year 1 and becomes PR 272,000 increased by PR 32,500 to PR 304,500 on account of one half of the additions made in year 1. The limit on repairs and improvements for year 2 is 5% x PR 272,000 (the opening balance before increase for additions).

The rates of depreciation assigned to the various categories are intended to reflect an approximate measure of economic depreciation based upon composite useful economic lives. Engineering studies for a particular country might determine different percentages or an additional class or two to be appropriate for that country. The intention was not to provide faster than economic depreciation. Nevertheless the assignment of the great bulk of assets on a composite basis to a limited number of classes and the use of a constant percentage rate applied to the balance in the pooled account are major contributions to administrative simplicity. Accounting for individual asset lives and accounting by year of acquisition are eliminated, making depreciation much easier to compute and audit.

A number of countries have financial accounting statutes that prescribe detailed accounts for individual assets or species of assets acquired each year. Regardless of whether a country requires such accounting for depreciation for financial reports, the group method of accounting for tax purposes is administratively desirable to avoid time wasting audits of complex depreciation accounts by agents. Such audits prevent them from productive work on serious compliance problems. Most small taxpayers will not need to employ financial accounting, which is meant to protect creditors and investors. For the larger enterprises, keeping a separate record of two or three pools is not difficult at all. Amounts of individual investments made each year are simply added up and credited to the pool. Thereafter the pool is managed as a running aggregate account.

The pooled accounting described here, however, might well be considered better for financial purposes. The proper charge against a particular year's earnings for wear and tear of assets is more accurately predictable on an aggregate basis than by treating the useful life of an individual asset separately from the entire stock of depreciable assets. The precision prescribed by individual accounts is misleading. Some have questioned the inability to report separately gains and losses on dispositions of individual assets as a distortion of the amount of operating earnings in a particular year. This overlooks the fact that gains and losses on the disposition of particular items of depreciable assets are usually attributable to either inflation or correction of underreporting or overreporting of depreciation in prior years. Thus the pooled accounting treatment here recommended really corrects previous distortions of operating results.

Sec. 37. Depletion.

Section 37 deals with depletion of natural resources. Even if the deposits themselves are owned by the state and hence not depletable by private taxpayers with contracts to remove them, all exploration and development costs must be capitalized and depleted. Total costs are then deducted by estimating the number of units of production expected from the natural resources deposit and prorating the cost to the units recovered during the taxable year. As indicated in the introduction, in addition to the regular entity income tax, countries owning natural resources will want to explore a variety of options as compensation for the grant of rights of exploitation of those resources.

Sec. 38. Charitable Contributions.

Section 38 provides for a charitable contribution deduction for individuals and businesses that can amount to 5% of taxable income without the contribution. Only contributions in excess of 2% of taxable income and not in excess of 7% of taxable income are allowed. The reasons for disregarding contributions up to 2% of taxable income are twofold. A 2% floor eliminates small contributors from audit and accounting needs and discourages exaggerated claims that are hard to substantiate. It avoids the necessity of filing returns to claim the deduction in the case of individuals who otherwise would have their liability satisfied completely by withholding on their wages and interest.

Second, minimal contributions are not likely to be spurred by tax incentives, so the efficiency of the tax incentive is increased by limiting it to contributions beyond the 2% threshold. The contribution must be made to a qualified non-profit charitable, religious, literary, educational, or scientific organization that is exempt from taxation under Section 91. A donation of property rather than cash will be treated as a sale of the property under Section 56. The full market value of the property will be deductible, but the gain will be included in the donor's income. In measuring the taxable income for purposes of determining the 2% threshold and the 7% maximum limit for the deduction, the taxable income will include the gain. The Tax Administrator will prescribe regulations requiring appropriate verification of contributions.

Some commentators have suggested that deductions should be available only for business expenses and that many charitable contributions, particularly by individuals, are not primarily connected with the operation of a business. However, we believe that the difficulty of drawing a line between business and non-business giving, plus the desire we have found in a number of countries to provide specifically a tax incentive to promote private charitable endeavors, makes inclusion of this limited deduction appropriate.

Sec. 39. Business Loss Carryforward.

Section 39 provides for a carryforward of business net operating losses for five years until they are used up by income in those years. Such losses arise in any year in which deductions from business exceed includible income derived from a business.

Even if the statute of limitations bars reconsideration of tax liability for a year in which a loss arose, the taxable income of that year may be revised to determine the correct amount of loss available to carry over to an open year. For example, assume a loss of PR 1,000,000 has been reported for year 1, which is closed by the statute of limitations at the time of audit of year 4. If the designated officer establishes that there was actually no loss in year 1 but income, or that the actual loss was smaller than PR 1,000,000, the reported determination of tax for year 1 may be recomputed to determine the correct amount of loss carryover to year 4. The loss could be eliminated for carryover purposes, if the facts warrant, but tax may not be assessed for year 1, even if it is redetermined that there was positive income for year 1.

Sec. 40. Treatment of Investment Expenses.

Section 40 deals with the investment activities of the taxpayer. Section 16 defines an "investment activity" as one entered into for profit when the taxpayer does not participate in the management of the activity on a regular, continuous, and substantial basis. This may take the form of holding stock or bonds, the holding of land or buildings on a net lease basis, the holding of mineral property for royalties (other than an operating interest), or the like.

Section 40(a) lumps all these investment activities together and allows the taxpayer to deduct the investment expenses for the year in excess of a PR 1000 threshold to the extent they do not exceed the investment income for the year. Any excess of deductions can be used as a carryforward for five tax years. Securities losses (discussed below) are not investment expenses for purposes of the PR 1000 threshold.

Because the taxpayer ordinarily has control over when gains and losses are realized from the disposition of stock, bonds, and other securities that are investment assets, these dispositions are treated separately in Section 53(a). Losses from such dispositions may be allowed, but only to the extent they do not exceed gains from the dispositions during the year of securities held for investment. An excess of such gains is taken into account in determining gross income for the current year. Under Section 53(a) an excess of such losses for the year is carried over and treated as a securities loss incurred in the next tax year. However, in the year in which an individual dies, the securities losses are allowed without regard to whether there are any offsetting securities gains.

Items of investment expenditure that would be required to be capitalized if incurred in a business under the rules of Section 32 would similarly be capitalized as costs of the investment, rather than immediately deducted as investment expenses.

The charitable deduction is not allowed in determining investment operational income. However, the charitable deduction would be allowed against the individual's total includible income.

Chapter 4. Gains and Losses and Related Matters.

Chapter 4 deals with the calculation and treatment of gains and losses from the sale, exchange, or other disposition of property.

Sec. 51. Definitions Related to Assets.

Section 51(a) deals with the basis of assets used to determine gain or loss. Some countries use the term "tax cost" or "fiscal cost" to express the concept that is here called "basis." Usually the basis of an asset is the cost or original amount the owner paid for the asset. But there are other starting points from which basis may be determined. For example, if the receipt of property is accounted for as income to the taxpayer, its fair market value (or the amount accounted for as income) becomes its basis. Because cost is a misleading term, we decided to continue to use the word "basis," knowing that each country will use its own term in translation. It also seemed to us that in English, the word "basis" better reflects the meaning because the amount referred to is the "basis" upon which calculations of gain or loss are made.

The Code itself may have a special rule for the basis of an asset acquired in a particular type of transaction. For example, Section 56(a) provides that the recipient of a gift start out with a basis equal to the amount at which the gift item was valued for purposes of determining the tax treatment of the person making the gift. In the case of certain transfers (such as the transfer of property between spouses and former spouses under Section 54), the recipient's basis will be the adjusted basis of the transferor. In the case of tax free exchanges (such as pursuant to entity reorganizations) the taxpayer's basis in property received in the exchange is usually the taxpayer's adjusted basis in the property surrendered in the exchange. In the case of both these transfers and these tax free exchanges the original basis is "adjusted" for additional consideration. That is to say, if the taxpayer has to part with money or other additional consideration, the basis will be increased by the amount of the additional consideration. If the taxpayer receives consideration in addition to the property in question, the basis for the property is correspondingly reduced.

A very difficult problem arises as to how to deal with the transition to the Code's gain and loss rules. One possibility is the revaluation of all assets at market value on the effective date of the Code. This would be very difficult to administer, since evidence of value is difficult to come by, especially if it is first needed many years afterward. Another method would be to take original cost less depreciation claimed under prior laws and to index the remainder from a table of inflation that has occurred since the date of acquisition up to the effective date. This might be more administrable. We adopted a third solution in the second sentence of Section 51(b), simply providing that adjustments for prior periods be made under prior laws without referring to an inflation adjustment. This is simplest, and may be acceptable if the amount of assets involved is not large. Otherwise some allowance for inflation is likely called for.

Section 51(b) deals with other adjustments that are made to the original basis. For example, the taxpayer will each year recover part of the original investment in depreciable property through a depreciation deduction. This will reduce the basis for the property. On the other hand, substantial improvements may be made in the property from time to time. The expenditures for these improvements will increase the basis for the property.

Sec. 52. Recognition and Amount of Gain or Loss.

Section 52(a) contains the general rule that when property is disposed of the entire amount of the gain or loss is to be taken into account for tax purposes.

Subsections (b), (c), and (d) of Section 52 tell how to measure that gain or loss. First one determines the amount realized on the disposition of the property. That is to say, one adds up all the money and the fair market value of the property one receives for its disposition. Any indebtedness either assumed or forgiven in the transaction by the other party is taken into account as if it were additional amount received. The total of the amounts received on the disposition is the amount "realized." Then one compares this sum with the adjusted basis of the property disposed of. If the amount realized exceeds the adjusted basis, the difference is the gain. If the adjusted basis exceeds the amount realized, the difference is the loss on the transaction.

The fact that a gain or loss is "realized" on the disposition of property does not necessarily mean that it is accounted for in determining taxable income. Usually realized gains or losses are "recognized," that is to say, accounted for in determining taxable income. However, the Code provides a number of situations where a gain or loss, even though realized by a disposition, is nevertheless not "recognized," that is, it is not presently taken into account in determining income. Examples are tax free exchanges in entity reorganizations (Chapter Seven) and Section 58 on Involuntary Conversions. If property is disposed of in exchange for other property, a gain or loss is almost always realized (there would be none if the value of the property sold or otherwise disposed of and its adjusted basis were the same). Gain or loss would also be recognized (that is, taxed) unless one of the nonrecognition provisions of the Code applies.

Sec. 53. Limitations on Recognition of Nonbusiness Assets Transactions.

Subsection (a) of Section 53 contains the limit on securities losses explained above under Section 40. The limitation on deducting losses from the disposition of securities is designed to prevent serious revenue losses in favor of taxpayers who have control over the timing of the disposition of the property. The revenue loss problem seems centered on sales of securities. Taxpayers will tend not to sell securities that will result in gain (to defer paying tax) and will tend to sell those that will result in loss (in order to get the earliest tax deduction). Hence if losses from sale of securities were allowed against other income, taxpayers would sit on their securities gains and use their losses to wipe out tax on other kinds of income. The problem is acute in the case of securities that are readily marketable. We do not believe it is a serious problem in the case of land and other types of assets that are not quickly convertible into cash by sale. Hence the opportunities to manipulate timing do not exist to any significant extent. We therefore limited the rule that quarantines losses (allowing them only to the extent of gains) to losses from disposition of securities. A "security" is a share of stock, a bond, or other evidence of indebtedness that is registered or negotiable, or other intangible assets that are publicly traded.

Subsection (b) of Section 53 contains the rule that no loss is allowed on the disposition of any personal asset (such as an automobile or personal residence).

Subsection (c) of section 53 permits gambling losses to be offset against any gambling gains the taxpayer has in the same tax year. There is no carry forward of gambling losses which exceed the gambling gains for the year. We sought in vain for a usable definition of gambling for this purpose. Generally it means participating in games of chance for stakes — that is, card games, lotteries, betting on racing or sporting events, dice, roulette, and the like. However, it does not include investments in high risk stocks. We believe that drawing the line between gambling and investing is better left to regulations than to a rigid statutory definition.

Sec. 54. Property Transfers Between Spouses.

Section 54 deals with the transfer of property between spouses and former spouses. There is no tax on property divisions in such cases. Conveyances are nondeductible and nontaxable as to both parties. Also the basis of property received by one spouse in a property settlement is the adjusted basis of the transferor spouse.

Sec. 55. Exclusion of Gain on Sale of Principal Residence.

Section 55 provides an exclusion from gross income on the sale or exchange of a principal residence occupied by the taxpayer for three consecutive years ending with the sale. The gain is based on a selling price of PR 500,000. If the selling price exceeds PR 500,000, a portion of the gain is excluded and the rest is taxable. To determine the excluded amount, multiply the total gain by a factor with a numerator of PR 500,000 and a denominator of the amount realized. The objective of the gain limitation is to limit what is taxable to gains from high cost housing, so that the lower income person whose whole savings are represented by a house is not taxed.

At least one commentator has pointed out that this limited exclusion for the sale of the taxpayer's residence is inconsistent with our attempt to avoid tax incentives and to have a broad income tax base. We plead guilty, and can only say that this provision is widely approved by legislators in the countries we have visited.

Sec. 56. Gifts.

Section 56 treats the transfer of property by gift as a sale. A donor is treated as having sold donated property for its fair market value (or its adjusted basis, if higher) at the date of gift. Thus, no loss is realized on a gift. The donee takes the amount treated as realized by the donor as the basis of the acquired property. In the case of a sale for a price below fair market value, there may be a transaction that is part gift and part sale. If a taxpayer sells to his son property worth PR150,000 for PR100,000, there is a gift of PR50,000. Assume the taxpayer's adjusted basis of the property is PR60,000. The gain would be PR90,000.

Sec. 57. Property Passing at Death.

Section 57(a) provides the general rule that a decedent is treated as having sold on the date of death at its fair market value on such date all property other than exempt property. The decedent's successors' basis in such property is its fair market value at the date of death. Exempt property — the principal residence of the decedent, tangible personal property that is not business property or investment property, and certain income taxable to the successors as received — takes the adjusted basis of the decedent at the date of death. Works of art that are salable are business or investment property. Ordinary furniture is not, but valuable antiques are business or investment property. In the case of income that the decedent did not receive before death, such as pensions and accounts receivable, the person succeeding to each such item shall pay tax when it is received.

Section 57(d) contains an exception to the deemed sale at fair market value rule of Section 57(a). If a decedent leaves the controlling interest in a farm or other small business to the members of the decedent's immediate family, those members may elect to defer any potential gain on the controlling interest until they dispose of it. The adjusted basis of the controlling interest when they receive it will be the same as the decedent's adjusted basis. Section 57(d)(2) defines "small business," "immediate family," and "controlling interest" for purposes of this special relief provision.

We recognize the problem of limiting the exception as we have drafted the provision. We have not applied the exception to transfers during the taxpayer's lifetime by gift. We sought to avoid the problems of cumulating an exemption over one's lifetime. Second, we recognize that an exemption that is limited to business interests having a fixed maximum value creates a "notch" problem. If the business is valued at PR10,000,001, the entire gain becomes taxable. On the other hand to allow the exception for the first PR10,000,000 in the case of every decedent leaving a business interest would require assigning the exempt amount to the various assets making up the business interests. This problem would become acute where members of the family differed on how the exemption should be allocated.

Sec. 58. Nonrecognition of Gain on Certain Involuntary Conversions.

Section 58 permits the taxation of gain to be deferred in the case of an involuntary conversion if the amount realized is reinvested in like kind property. An involuntary conversion includes the destruction of property by casualty such as fire, flood, or other act of nature, expropriation, or condemnation or threat of condemnation. The proceeds received from the involuntary conversion include damages, insurance proceeds, or payment for taking by condemnation. To qualify for deferral the proceeds must be reinvested to acquire replacement property of a like kind to that converted during the two to three year replacement period specified in Section 58(c)(3). To the extent they are not, gain is recognized. If any gain is not recognized, the basis of the replacement property starts with the adjusted basis of the converted property. The adjusted basis of the converted property is decreased by the amount of money received that is not reinvested in the replacement property, and increased by the amount of gain recognized.

For example, a taxpayer owns a building with an adjusted basis of PR 100,000 and a value of PR 150,000. The building burns and the taxpayer receives insurance proceeds of PR 150,000. The taxpayer buys a replacement building for PR 140,000. The taxpayer's gain is PR 50,000, but since the taxpayer only retained cash of PR 10,000, only that part of the gain is taxable income. The PR 40,000 of gain represented by the reinvested proceeds is not included in income currently, but the adjusted basis of the replacement building remains PR 100,000 (old basis of PR 100,000 + PR 10,000 of recognized gain -PR 10,000 of cash retained).

Sec. 59. Certain Foreign Exchange Transactions.

Sec. 60. Losses on Certain Sales of Stock and Securities.

Sections 59 and 60 (as well as Section 76, relating to original issue discount) deal with matters that may seem at first glance to be too complex and sophisticated to belong in what is labeled as a "basic" tax system. However, these sections relate to matters that cannot be ignored if the tax system is to work in an equitable way and without serious loopholes through which significant revenue can escape.

Section 59 provides for a year end evaluation of the taxpayer's debt positions (either as a debtor or creditor) where the principal of the debt is payable in a foreign currency. The taxpayer will have to recognize income or loss at year end as if the debt had been settled for its fair market value. Although this deemed sale may seem unusual to those who expect tax results only when there is a completed transaction (such as an actual sale), this "mark to market" approach is perhaps the simplest solution to a very difficult problem.

Section 60 deals with certain sales of stock, bonds, and other securities. The taxpayer ordinarily has full control of the time when securities are sold. The taxpayer will usually want to speed up sales giving rise to tax losses, while postponing sales giving rise to gains. But if the taxpayer acquires a substitute for a loss security to be sold, either shortly before or shortly after the sale, the taxpayer could claim a loss even though from an economic standpoint there has been no significant change in the taxpayer's holdings. Section 60 is aimed at plugging this potential loophole.

Chapter 5. Accounting Provisions.

We believe that it is important that tax accounting be treated in the tax law under its own system separate from financial accounting. Of course, accrual tax accounting and financial accounting will largely be governed by the same principles. It is important, however, that the situations where different rules should apply be determined by those concerned with tax policy and administration. Rules for financial accounting are designed to protect investors and creditors and hence will err on the side of conservatism. They will encourage the delay in reporting income that the tax administrator should tax. An example is receipt of cash that is subject to unrestricted use of the taxpayer, such as payment of rent at the beginning of a five year lease. Under financial accounting only 1/5 of the rent would be taxed in the first year. Yet if the revenue administration fails to tax the receipt when it is the taxpayer's to dispose of without restrictions, it may find the money is gone at the time of later accrual. The opposite problem exists on the deduction side. Financial accounting encourages businesses to deduct reserves against all types of contingencies that may never arise. The tax administration is in no position to evaluate these guesses or to follow the course of events to verify that the liability is genuine. Hence no deductions should be allowed in absence of the highest degree of certainty. Finally small firms may find that cash accounting or some modified hybrid is more manageable than strict financial accrual accounting.

Sec. 71. Taxable Year.

Under Section 71 all taxpayers will report their income and pay tax on the basis of the calendar year. Admittedly there are sound business reasons and accounting workload reasons for permitting at least some taxpayers to use accounting periods other than the calendar year. However, the complexities this flexibility would require to prevent abusive deferrals of income caused us to opt for just one taxable year, the calendar year.

Sec. 72. Method of Accounting.

Under Section 72 natural persons may account on the cash or accrual method, but entities and pass-throughs are to account on the accrual method. In any event, the method of accounting must clearly reflect income. Natural persons with large businesses may be required to use accrual accounting for those businesses, if necessary to clearly reflect income. Regulations will set forth rules of general application to determine the situations in which the designated officer may require this use of accrual accounting. The designated officer may upon request permit other methods of accounting that clearly reflect income.

Some countries have tried to introduce legislative forms of "presumptive" taxation for taxpayers who cannot, or who are loath to, keep adequate books and records. They would prescribe an assumed income based perhaps on a taxpayer's turnover, or other external indicia, including the kind and geographical location of the business. We believe it is almost impossible to administer such rules in any reasonable way because of the wide variations that exist among businesses and location. Furthermore we would not want to encourage taxpayers of above average profitability to take advantage of a presumptive schedule to underreport income. Presumptive taxation does have a place in administration, but simply as a tool that an auditor may use in an appropriate case to require the taxpayer to prove what true income is, or otherwise to face a presumption that not all income has been reported.

We have not provided for an installment method of accounting for situations where a taxpayer sells property and realizes a gain but the buyer pays the purchase price over a period of several years. Some countries permit the tax to be paid proportionately as the installments are received. In that case it is important that the deferred tax paid as each installment is received include interest to compensate for the delay in paying tax.

Sec. 73. Cash and Accrual Methods of Accounting.

Under Section 73(a) taxpayers using the cash method in general report income and take deductions on a payment basis. There are some modifications. For example, the taxpayer does not have to have the payment in hand for it to be considered payment. Merely having the payment available on demand (whether the amount is in the control of the debtor or of a third party) is sufficient for an amount to be considered income.

Similarly, there are modifications of the actual payment rule on the deduction side. For example, the taxpayer cannot immediately deduct five years of rent paid on the signing of a lease. Instead, the rental deductions must be spread over the five years of renting. The same would be true of prepayment of several years of insurance premiums or interest attributable to later years. Also there are express provisions of the Code for the timing of certain deductions, such as the deduction for depreciation, amortization, and depletion (see Section 34 and following).

Section 73(b) sets forth the general rule for accrual accounting. Income is reported for the year in which it is earned but not later than the year in which the taxpayer receives it or could receive it on demand. This is true even if the income under strict accrual rules might be deferred — as in the case of prepaid rent. In general, deductions are taken for the year in which the expenses or other items are incurred.

Section 73(c) goes on to elaborate when expenses or other items are incurred. In order to be entitled to a deduction for a year three tests must be satisfied before the close of the year. The facts from which the taxpayer's liability can be ascertained must have occurred (for example, the other party must have fulfilled its obligations under the contract). Secondly, there must have been economic performance. And thirdly, a precise amount (or agreed on formula under which that amount can be readily determined) must have been determined for the taxpayer's liability.

Section 73(d) deals with the timing of deductions when the debtor is an accrual method taxpayer and a related party creditor is a cash method taxpayer. There the debtor must wait for payment before deducting the item (so the deduction will not be allowed at a time earlier than the reporting of income by the related creditor). Otherwise the parties will be able to connive for immediate deduction with no incentive for the related party ever to recognize income.

Sec. 74. Inventories.

Businesses with income from the sale of goods must maintain inventories to determine the cost of goods sold under Section 74. Because LIFO (a method under which the last goods purchased are treated as the first goods sold) is usually helpful to the taxpayer in an inflationary situation, the LIFO method is expressly mentioned in Section 74(b). However, it is expected that regulations will certainly permit a taxpayer to choose first-in-first-out (FIFO) or certain other inventory methods that may be appropriate for business in general or for specific business situations. In addition, in periods of inflation the inflation adjustment regulations under Section 79 will permit appropriate adjustment to take into account the current price level of the base stock or to index the FIFO inventory. Some countries have elaborate rules to require the capitalization of overhead costs attributable to the manufactured or purchased inventory. We would avoid very technical requirements that these costs be absorbed into inventory values on the grounds of administrative simplicity.

Sec. 75. Long Term Contracts.

Section 75 requires the income from long term contracts to be taxed on the percentage of completion method. At the completion of the contract, interest is either paid or charged to the taxpayer depending on whether the payments of tax based upon the actual percentages completed each year before completion would have been less than or greater than the original estimates. The recomputation of the proper tax based upon the actual percentages of completion is only hypothetical to determine the final interest charge or refund. The interest charge will discourage taxpayers from understating the percentage of completion during the earlier years of the work. The recomputed taxes for each year are not to be assessed for those earlier years, since any remainder of the total tax is paid with the return for the year of completion. Covered long term contracts are defined in Section 75(c).

Some countries may wish to modify the application of the look-back set forth in Section 75(b)(2). For example, they may exclude from the look-back contracts below a certain size. Or they may provide that the look-back will apply only when the originally reported income for a year was less than a specified percentage of the income reportable for that year (as determined on completion of the contract).

Sec. 76. Original Issue Discount.

Section 76 taxes original issue discount — the spread between the redemption price of a debt instrument at maturity and its issue price — as income accruing over the period that the instrument is outstanding. Such a provision is necessary to prevent abusive deferral of inclusion of interest income. In some western countries accrual basis borrowers were issuing bonds paying little or no interest until they matured many years in the future. The issuers were deducting interest accruals each year, while the bondholders were not reporting interest income until they received the bond's face value amount (which included all accrued interest) when the bond matured.

The rules under Section 76 are left to regulations so that considerations of administrability can be balanced against the need to prevent serious abuse. It is expected that the regulations will attempt to achieve a measure of simplicity consistent with the development and use of instruments issued at discount, but will correlate the inclusion of income by the lender with the deduction of accrued interest by the borrower.

Sec. 77. Income from Joint Property.

Section 77 treats income from jointly owned property as taxed to each separate owner proportionately to their ownership.

Sec. 78. Allocation of Income and Deductions Among Taxpayers.

Section 78 gives the designated officer authority to reallocate income, deductions, credits, and tax among commonly owned entities or businesses and their owners to reflect income properly and to prevent tax evasion. This authority includes power to recharacterize transactions between related parties. Economic reality controls. The designated officer will apply arm's length standards for judging any transactions between related parties. This section gives full authority to insure correct transfer pricing of imported and exported goods.

Sec. 79. Adjustment for Inflation.

Severe inflation will cause great damage to, and may even destroy, even the best drafted income tax law. Countries experiencing severe inflation have pursued various courses. Many have done nothing. Others have made piecemeal adjustments from time to time (such as increasing the brackets and revaluing some assets). Still others, such as Chile and Mexico, have adopted comprehensive schemes for mandatory periodic adjustments to most of the important items entering into income tax liability.

Obviously, the best solution is to get inflation under control. Because this is not always a feasible solution (particularly in the short run), Section 79 attempts to outline a middle of the road, flexible approach permitting the tax system to coexist with inflation.

Section 79(a) requires the Tax Administrator to publish an inflation percentage for any calendar year during which the Designated Price Index rises 5% or more.

Section 79(b) provides that for any year for which there is at least 5% inflation, the Tax Administrator must set in motion either:

(1) a limited set of adjustments called a "bracket adjustment," or

(2) a much more complete set of adjustments called a "comprehensive adjustment."

Section 79(c) describes the matters affected by a bracket adjustment, while Section 79(d) sets forth the steps to be taken in a comprehensive adjustment.

Section 79(e) describes the price index to be used both to measure the severity of the inflation and to determine the percentage adjustment required. Some countries wish to conceal the magnitude of their inflation to restrain pressures for greater wage adjustments. Others will wish to use the legal minimum monthly or annual wage as a substitute for a price index. However, changes in the official minimum wage often more accurately reflect political considerations than they do inflation. For these reasons Section 79(e) contemplates that the Central Bank will maintain one or more price indexes and that the Tax Administrator will designate the one broad-based index (such as the gross domestic product deflator) most appropriate to carry out the purpose of Section 79.

In any comprehensive adjustment for inflation one of the most troubling questions is what to do about debt. While the person to whom the money is owed is losing because the money received (in interest payments and in principal repayment) has less and less purchasing power, the person who owes the money is enjoying corresponding gains. Some commentators have suggested that the debtor must be treated as realizing income from inflation, income that should be taxed in full currently.

Section 79 does not take this approach. Instead it shrinks out the debt of the business on an overall basis as of the beginning of the tax accounting period. The remaining net equity in the business or investment activity (see Section 79(d)(2)) is increased to reflect inflation and the increase is then spread among the assets of the activity to increase adjusted bases of assets on a pro rata basis. It may also be necessary to make adjustments for contributions to capital of the entity during the year and withdrawals from the entity, such as dividends, to place the closing equity on a comparable basis to the opening equity.

Space precludes a full discussion of the problems and techniques of implementing such an indexing system. Some useful papers on the subject are Comment by Arnold C. Harberger in Aaron, Galper and Pechman, Uneasy Compromise (The Brookings Institution 1988); Conrad, "Dividend Relief and Inflation Adjustments: Possible Options for Tax Systems in Emerging Economies," Harvard University International Tax Program Symposium "Directions in Tax Reform in Emerging Economies," November 1, 1991; and Thuronyi, "Adjusting Taxes for Inflation," Chapter 3 of a forthcoming book to be published by the International Monetary Fund to be entitled Tax Legislation for Developing and Transition Countries.

Of the three papers Harberger proposes the simplest adjustment system. He suggests that business income can be indexed through just three operations:

(1) Write up all real assets by the inflationary adjustment percentage, and enter the amount of the write up as an income item.

(2) Write up all real or indexed liabilities and all owners' equity (capital and surplus) by the inflationary adjustment percentage, and enter the amount of this writeup as a loss item.

(3) Calculate depreciation on the basis of the written-up values of physical assets (as determined in step (1) above).

Thuronyi's paper presents the most detailed indexing proposal. It contains a draft of a proposed income tax indexing system. The draft is based on a system adopted by Chile and is similar to systems in effect in a number of other Latin American countries that have experienced periods of severe inflation.

Conrad's paper is a modified version of the Harberger proposal. The modifications deal primarily with the treatment of:

(1) domestic credit instruments (whether owed by or owed to the taxpayer),

(2) all instruments (equity and debt) specified in foreign currency, and

(3) inventory.

The comprehensive adjustment set forth in section 79 is based on one of the alternative solutions contained in the Conrad paper.

Chapter 6. Exempt Income; Unrelated Business Income.

Under Section 91 the income of listed not for profit organizations is exempt, unless it is derived from a commercial activity not directly related to the exempt function. The listed organizations include governments; religious, charitable, scientific, literary, or educational organizations; and labor unions and trade associations. A not-for-profit charitable hospital may charge for its services without being taxed on income from such charges since they are related to its exempt function of furnishing hospital services. The regulations will provide for annual reporting by listed organizations to verify their exempt status, and for loss of exemption for prohibited transactions inconsistent with their exempt nature.

Sec. 92. Treatment of Income of Unrelated Business.

Section 92 provides for taxation of income from unrelated commercial activity, whether the organization is a government or a private exempt organization. The distinction between governmental non-commercial functions and commercial functions is explained above in connection with Section 12(c). The transfer of funds from an unrelated business to the general coffers of the organization is treated as a dividend subject to withholding under Section 164, unless the organization can prove to the contrary that it had some other business purpose beyond repatriation of funds.

Sec. 93. Foreign Diplomatic and Consular Income.

Section 93 exempts compensation of foreign diplomats and their foreign staff from the exercise of their representation in Progresa. The same exemption applies to foreign representatives and employees of international agencies.

Chapter 7. Entity, Organizations, Reorganizations, Liquidations, Etc.

Chapter 7 deals with the organization, reorganization, and liquidation of entities.

Sec. 101. Contributions to Capital.

Contributions to capital of an entity do not constitute income to the entity. Further, under Section 101 the transfer of property to an entity in exchange for an equity interest in the entity by one or more persons who after the transfer own 80% or more of the equity interests of the entity is a non taxable exchange since it does not essentially change the ownership interest of the transferors, but rather simply changes the form of holding assets or carrying on a business. Under Section 51(a) the transferor will carry over his or her basis of the transferred property to be the basis of his or her equity interest in the entity, and under Section 101 the entity's basis in the property received will be that of the transferor. Thus, any gain inherent in the transferred property will ultimately be recognized.

Sec. 102. Distributions by an Entity.

Section 102 provides that in the case of any distribution by an entity (as defined in Section 12(c)) of property other than cash or its own stock, whether or not in liquidation, the entity is to recognize gain or loss as if the property had been sold for its fair market value at the date of distribution. Fair market value is the price that would be realized in an arm's length transaction. The basis of the distributed property to the transferee will be its fair market value. Under Section 14 a distribution other than one in complete liquidation is to be treated as a dividend to the recipient and is subject to the withholding treatment prescribed under Section 164. However, under Section 102(b), dividends in stock that do not change the share of participation of the recipients are not included in gross income. Nor does gross income of recipients include dividends from which tax is withheld under Section 164. See Section 164(e).

The basis of stock received as a stock dividend is the fair market value of the stock received in the case of a taxable stock dividend. However, in the case of a non-taxable stock dividend described in Section 102(b), the basis of the old stock is divided between the old shares and the dividend shares proportionately.

Sec. 103. Liquidations.

Section 103 deals with liquidations. A partial liquidation is treated as a dividend under Sections 14 and 103 and is subject to withholding creditable against advance tax under Section 164(b). A complete liquidation is not treated as a dividend to the shareholders of the entity. A liquidation pursuant to a plan may take place in a series of steps over a reasonable time (perhaps a period of 12 months). The shareholders receiving a distribution or distributions in complete liquidation treat the proceeds received to the extent their fair market value exceeds adjusted basis as a gain from the sale of the owner's interest. However, if an entity receives property in complete liquidation of another entity it owns, gain or loss is not recognized at that point.

If the property received in a liquidation is an equity interest in a party to a qualified reorganization that may be received without recognition of gain under Section 104, the reorganization provisions override Section 103. Under Section 105(f)(1), only the portion received that is not an equity interest in the surviving entity is treated as received in liquidation. Some countries may prefer not to tax the recipients of complete liquidations to the extent that the distribution represents retained earnings that have already been taxed at the corporate level.

Sec. 104. Qualified Reorganizations of Entities.

Section 104 provides that, in the case of qualified reorganizations, transfers among the parties are not taxable events. Property received by an entity will carry over the basis of the transferor in the transferred property. The equity interest received by shareholders will generally receive as its basis the basis of the property transferred. Thus stock in an acquiring entity received in exchange for stock of an acquired entity by shareholders of an acquired entity will take the shareholders' basis of their old stock. The acquiring entity will succeed to tax attributes of the acquired entity as enumerated in Section 104(c).

Sec. 105. Definitions and Rules Relating to Reorganization of Entities.

Section 105 describes the types of entity reorganizations eligible for the tax free treatment of Section 104. They are essentially continuations of the same business in different form and do not constitute dispositions of a business interest as to which gain is appropriately recognized. Income will be recognized, however, to the extent of property received other than a continuing equity interest in the enterprise, and gain will be taxable to that extent. For example, if a shareholder receives stock in the acquiring entity for his or her shares of the acquired entity, and also cash, gain will be recognized to the amount of cash. The transferor's basis in the property received tax free will be appropriately increased to account for recognized gain.

Section 105(b) defines "control" in terms of ownership of 80% of the voting power plus 80% of each non-voting class of stock.

Section 105(c) in effect requires a significant non-tax business purpose to be a qualified reorganization.

Section 105(f)(2) permits a series of transactions to be viewed as an integrated whole to recognize its substance, rather than judging each element separately. Section 105(f)(3) gives the Tax Service power to look at substance rather than form to determine if a qualified reorganization has occurred.

Some countries may be apprehensive about the complexity of the reorganization provisions of chapter 7. However, it is likely that generally reorganizations will involve only taxpayers of sufficient sophistication to cope with them.

On the other hand it will be very understandable if countries wish to substitute for chapter 7 a far simpler provision, such as that the tax treatment of reorganizations is to be determined under regulations or under written rulings issued by the Tax Service. Such an approach is provided in Section 106 for cases where one or more of the entities concerned is a nonresident person.

Whatever course a country takes, it should realize that unless there are adequate provisions dealing with reorganizations many of the income tax rules will be avoided. Artificial restructurings of business activities will be claimed to be tax-free reorganizations even though in substance they are sales, distributions, or other transactions going beyond the continuation of the same business activity by its owners in a new form.

Sec. 106. Advance Approval Required Where Nonresident Person Involved.

Section 106 provides that a transaction otherwise qualifying for non-recognition under Section 101 or Section 103(b)(2) or as a reorganization under Section 104 will not qualify under such sections if one of the persons involved is a nonresident of Progresa unless advance approval of non-recognition status is given by the tax administration.

Chapter 8. Rules Relating to Pass-Throughs.

Chapter 8 provides rules for taxation of members of pass-throughs. The pass-through does not pay the entity tax referred to in Section 3. Determinations with respect to its income are made under the accrual method of accounting as if it were an individual without the charitable deduction or the carryforward of business and investment losses.

Each member then takes into account separately his or her share of the tax items of the entity, including the charitable contributions made by the pass-through. Income of the pass-through is included in the income of the member each year whether or not distributed. Distributions themselves are not taxable except to the extent they exceed a member's adjusted basis. Distributions in kind, however, are treated as sales at fair market value. The basis of property received as a distribution in kind will be an amount equal to its grossed up fair market value at distribution.

Section 111(c) limits losses of a member of a pass-through to the basis of the member's interest. Excess losses flowing through to the member would be carried forward until basis is created by flow through of income or additional investment.

Sec. 113. Member's Adjusted Basis.

The adjusted basis of a member's interest is increased by the distributive share of gains and other income and reduced by distributions and the member's share of deductions and losses.

Sec. 114. Regulations.

Regulations will prescribe special rules to carry out the proposed treatment of pass-throughs. Under the regulations, the pass-through may be treated as an entity for imposing obligations as a withholding agent. In particular, regulations will prescribe the treatment of debt of the pass-through in determining the basis of members' interests.

Treatment of Investment Companies As Pass-Throughs

The question arises as to how investment companies should be treated. Many countries are using investment companies to privatize their economies. The investment company will hold the shares of a number of operating companies and individuals will own the shares of the investment company. So long as the single tax approach of Section 164 is followed, the investment company will not pay tax (beyond the withheld tax applied by its payor against the payor's entity tax) on dividends from investments in domestic entities of which it owns at least 20%. A country may wish to do away with the 20% threshold for qualified investment companies, so all domestic dividends may be distributed to the investment company's shareholders free of further tax.

There is an alternative mechanism that could be enacted to deal with the problem, and it should be considered, especially if the country enacts a second tax on dividends. The mechanism would treat an investment company as a mutual fund by equating the tax treatment of shareholders to that which they would bear if they owned the mutual fund's assets directly. Following is an outline of the alternative.

It would apply only to a qualified investment entity that meets these conditions:

1. It is a resident entity.

2. It has at least 100 shareholders, all of whom are individuals.

3. It has no shareholder that is an entity.

4. It has no shareholder who is a 5% owner (as defined in Section 136(d)).

5. It holds only permitted investment property (presumably shares and qualified debt instruments) with the diversification required by regulations.

6. It distributes to its shareholders with respect to each year, by January 31 following such year, all of its income (including net gains).

7. It meets such other requirements as regulations prescribe.

Such a qualified investment entity would be exempt from withholding tax as payor to its shareholders on all its dividends paid. It would pay entity tax on its interest and foreign entity dividends received and net gains. Its dividends from domestic entities would have been subject to the same withholding taxes as an individual owner. It could be provided that its net investment losses from dispositions of property could be passed through to shareholders. The income ultimately received by low-income individual shareholders would still have been subject to a 30% tax rate, but that is a defect we have elected to tolerate in the basic integration system of Section 164.

Chapter 9. Pensions.

Chapter 9 provides special treatment for contributions under qualified pension plans.

Sec. 121. Treatment of Qualified Pension Plans.

Section 121 provides a special exclusion from income for employer contributions, and a corresponding special deduction for a contribution by an employee or self-employed individual, to a qualified pension plan. The combined exclusion and deduction may be up to 15% of earned income as defined in Section 121(c) for any year. Earned income is wage or salary income from employment or income from self-employment by an independent provider of services. No carryovers from year to year of the unused portion of allowable deductions are permitted. Under Section 162(c)(2) an employer paid contribution within the 15% limit is not a fringe benefit. The distributions from the pension fund, including those based on interest earnings credited to the recipient of the distributions, are included under Section 13 and Section 121(d) in gross income as received. We have deleted a provision that was in the Preliminary Edition that allowed dividends received by pension funds to continue their tax free status when distributed as pensions on the ground of complexity. If the complexity is tolerable, it could be restored. All contributions for or by workers and income earned on them are vested in the account owner. Section 121(d) provides for exemption for the fund from entity taxation on earnings, as well as providing for recipient taxation in the case of distributions.

Section 121(e) sets forth standards required for a plan to be treated as a qualified pension plan. The plan must cover at least 90% of the full time employees with one year of service. The plan must be exclusively for employees and their beneficiaries. Funds are held by a separate legal entity, be it a bank, insurance company, trust fund, or similar entity. Individual accounts will be kept for each employee. The amount held for an employee in this account may be used to purchase an annuity contract for the employee. Other than such a purchase, the provisions do not contemplate funding fixed benefit pension plans as opposed to accumulations based upon contributions. Employees are immediately vested in all contributions credited to their accounts but the distribution of funds will not commence until at or after attainment of age 55. Distributions must commence at age 70. On death, however, all accumulations must be distributed to the employee's beneficiary.

Withdrawals are subject to tax and withholding. No loans are permitted from a qualified plan to an employee. Instead, amounts paid to an employee are treated as taxable distributions.

Sec. 122. Foreign Pension Plans.

In order to attract foreign investment, together with the specialized foreign workers needed for temporary periods to set up the foreign investment and to get it running, it may be necessary to include special provisions dealing with pension plans maintained by nonresident employers. Absent such provisions, contributions on behalf of foreign nationals working in Progresa would be deemed to be income from Progresa. Their taxation by Progresa might disrupt long-standing agreements between the nonresidents and their employees.

Section 122 authorizes regulations excluding from gross income contributions to (and accumulations in) foreign pension plans that qualify under Section 122(b). However, this exclusion is available only for foreign nationals who can reasonably be expected to be in Progresa for not to exceed 5 years.

Chapter 10. Cross Border Provisions.

Subchapter A — Tax Treatment of Nonresidents.

Section 131. Taxable Income of Nonresidents.

As explained above (see Section 2), nonresidents (whether entities or individuals) are taxable only on income from Progresa sources. Similarly their deductions are limited to those allocable to the production of Progresa-source income.

Section 131(b) provides that permanent establishments (defined in Section 12(e)) are to be treated as resident entities, regardless of whether they are maintained by a nonresident entity or a nonresident individual. However, the income subject to Title I tax will be only the Progresa sourced income. And the deductions allowed will be only those properly allocable to Progresa income.

Sec. 132. Gain When Individual Ceases to be Progresa Resident.

Section 132(a) provides for a deemed sale of the investment and financial property of an individual when an individual who has met the requirements of Section 12(h) for being a resident individual ceases to meet those requirements. The date of cessation will be determined in the manner provided by regulations.

Section 132(b) gives individuals becoming Progresa residents an election to establish the fair market value at that time of their investment and financial property. This ensures that if they later cease to be Progresa residents, they will be taxed only on gains accruing during their residency in Progresa.

Sec. 133. Credits.

Section 133 allows a nonresident individual the credit for any tax withheld on wages under Section 171 and for any tax on property transfers withheld under Section 174, but only if the individual files a return of tax under Title I for the tax year.

Subchapter B — Foreign Income of Progresa Residents.

Under Section 2 a resident of Progresa (whether entity or individual) is not taxed on worldwide income but just Progresa income plus foreign investment and financial income. For a discussion of what constitutes foreign investment and financial income, see the explanation above under Section 2. While it is clear that operating income received directly from a nonresident entity actively conducting its business outside of Progresa will not constitute foreign investment and financial income, the special treatment of this type of income necessitates the drawing of additional lines in Sections 136 and 137.

Sec. 136. Look Through in Case of Certain Investment Entities.

Section 136(a) taxes to 5 percent owners the income of a nonresident entity which either —

(1) derives more than 50% of its total income from foreign investment and financial income, or

(2) is formed or availed of to shield any Progresa resident from tax on such income.

Section 136 also defines 5 percent owners, permits the passing through of the foreign entities' foreign taxes, and permits actual distributions to be received tax free.

Sec. 137. Dividends of 10% Owners from Foreign Business Operations.

Section 137 is designed to make it clear that dividend income from direct investment in active businesses operating outside of Progresa is not to be taxed under Title I. For this purpose direct investment is the ownership of 10% or more of the stock or other equity interests of the business.

Subchapter C — Sources of Income.

Sec. 141. Division of Income.

Section 141 contains the general rule that income is to be divided between Progresa and the rest of the world on the basis of the place where the economic activity that produced the income took place.

Sec. 142. Specific Rules for Progresa Income.

Section 142 sets forth specific rules for allocating income to Progresa. These rules are not the only possible rules. For example, some commentators believe that royalty income (see paragraph (5) of Section 142) should be assigned to the country of residence of the person paying the royalty. Also, very elaborate rules have been worked out in some countries for gain from the sale of movable property (see paragraph (7) of Section 142). Under these rules the gain could be assigned to more than one country where more than one country had allowed depreciation deductions to the seller of the movable property.

We excluded inventory from the rule of Section 142(7) and left it to the general rule of Section 141(b). In the case of inventory manufactured in one country and sold in another, there is economic activity assignable to both countries. Regulations may use a formulary approach, or a hypothetical transfer pricing analysis, if one entity does the manufacturing and the selling.

Sec. 143. Specific Rules for Foreign Income.

Under Section 143 income is allocated to a foreign country if that result would be reached under a Section 142 that contained the name of the foreign country instead of Progresa.

Subchapter D — Tax Treaties.

Sec. 146. Tax Treaties.

Section 146 states that the provisions of the Code are to yield to any tax treaty entered into by Progresa that contravenes those provisions.

In some of the countries we have visited we have been asked to recommend a tax treaty to serve as a bench mark for treaty negotiators.

There are a number of model tax treaties that could serve this purpose. Of these we prefer the OECD model as it is the basis for most of the others and because it has the most extensive commentary.

Chapter 11. Banks and Insurance Companies.

These entities present special problems for income and value added taxes. It is difficult to determine their income or the value they add by their activities as intermediaries, particularly in view of their need for protection against abnormal losses. One proposed solution is to exempt them from income tax, value added tax, or both. Instead they would pay an annual tax of a small percentage (perhaps 1 or 2%) of the value of their gross assets.

Although we have not adopted this solution in toto, we are proposing a modified version of it. While the financial service income of bnaks and insurance companies would be exempted from the value added tax under sectin 211(c)(5), both banks and insurance companies would be subject to the income tax. The banks would be subject to the requirement that the reserve for bad debts be based on experience (see Section 151). Insurance companies would substitute a 10% tax on gross premiums for the 30% tax on taxable income under Section 1 (see Section 152). And both banks and insurance companies would be subject to a modified gross assets tax under Section 471 (see Section 473(d) for modifications).

Sec. 151. Loss Reserves for Banks.

Section 151 permits financial institutions to use a reserve method of accounting based upon experience for loan losses.

Sec. 152. Treatment of Insurance Companies.

Section 152 exempts insurance companies from the regular 30% entity income tax. Instead, a 10% tax is imposed upon their gross premiums accrued for insurance or reinsurance of Progresa risks. Non insurance activities are treated as conducted in a separate entity subject to normal tax. This section avoids the complexity of determining income of an insurance company and the appropriateness of its reserves. A country may, however, choose to keep casualty insurance companies under the regular income tax, because the problem of reserves is far less complex. Section 164(b) closes a potential loophole because it provides that the credit for the advance tax on distributions will not be allowed against this tax measured by gross insurance premiums.

Chapter 12. Related Taxes.

Sec. 161. Fringe Benefit Tax.

Section 161 imposes a 30% tax payable monthly on the grossed up value of fringe benefits provided by an employer to its employees and certain independent contractors. The value of the fringe benefits would then be excluded from the income of the recipients. Taxing at the level of a single payor for all of its workers avoids difficult problems of administration encountered when taxation is imposed separately upon each recipient worker.

Many countries treat the provision of fringe benefits by an employer to a worker as additional compensation subject to withholding tax applicable to cash wages and salaries. The amount of such compensation subject to the withholding tax is the fair market value of the benefit furnished to the worker. Indeed since Section 13(a) includes "all income from whatever source derived," and Section 13(b) explicitly includes in gross income "compensation for services," such would be the rule under the BWTC but for the exclusion under Section 13(c) of "fringe benefits taxable under Section 161." Neither Section 13(a) nor Section 13(b) is limited to receipts in cash, and both are broad enough to include benefits received in kind.

In the broadest sense of the term, "fringe benefits" refers to compensatory payments that are furnished to the recipient beyond regular cash wages or salaries (including bonuses). In almost every instance, however, income tax laws exclude some specified fringe benefit payments from taxation. Examples of some exclusions in one country or another (some of which are in the BWTC) are an amount of life and health insurance premiums paid by the employer, pension plan contributions, educational benefits paid for by the employer for the worker or family members, meals and lodging furnished by the employer free or at subsidized prices, whether or not on the employer's premises, recreational facilities, discounts on merchandise sold by the employer to the worker, and many others.

Two questions are perplexing to the administrators of an income tax. Is the particular benefit (in the absence of a specific reference) taxable compensation at all? For example some benefits such as a fine office or job related training would not be regarded as taxable compensation at all, but rather part of the normal working conditions of the worker. Once it is established, however, that a benefit is part of taxable compensation of the worker, a second, frequently more difficult, question arises: what is the value to be included in the worker's income and presumably the base for withholding of tax by the employer? This involves problems of determining the value of a difficult to value item such as a discount on the sale to an employee from the employer's inventory of merchandise, or the personal use of a car, or meals or lodging tied to the necessity of work (as a hotel clerk with lodging on the premises). What is the value of an airline seat furnished to an employee on an otherwise half empty flight, particularly if there are a number of fares paid by different passengers for the same seat depending on their circumstances (such as cancellation or rebooking rights, advance purchase, etc.)? Does it matter that there was no additional cost to the employer since the plane was otherwise flying with an empty seat?

Governments that are lax in their enforcement of includibility of fringe benefits in income will find that more and more employers and workers will cooperate to create compensation arrangements by way of fringe benefits as substitutes for cash wages. There will be a serious erosion of the tax base as tax is not paid on these alternative forms of compensation (although the costs to the employers will be fully deducted). Moreover economic distortions will occur if particular types of fringe benefits are tax preferred. For example if health insurance premiums were treated as tax free to the worker, it would encourage that form of compensation almost universally to an extent that might not be sound. The ideal situation would be for of all compensation to be paid in cash and fully taxable, with the opportunity to the recipients to choose the disposition of the cash compensation at market prices.

Taxing and auditing fringe benefit compensation at the employee level involves a very broad audit program that is difficult for even the most sophisticated and experienced audit systems. It is not possible to audit all employees on a one by one basis. It is frequently difficult to detect the receipt of fringe benefits. It is difficult to allocate the benefit to each particular employee, particularly if the benefits are provided on a mass, rather than an individual, basis, as in the case of employer provided recreational or dining facilities. Even when the benefit is identified, the assignment of a value can be difficult and controversial. Hence our choice to tax at the employer level, if possible.

This fringe benefits tax applies to all employers or other persons providing fringe benefits, including governmental and non-profit employers that may not be subject to income tax. The tax cannot be avoided by having another person pay the fringe benefits. The tax will apply to the payor, or if the payor is not subject to Progresa jurisdiction as in the case of a nonresident parent, the domestic payor will be treated as the constructive employer and will be subject to the tax. Employers must aggregate for all their recipient workers for each month fringe benefits of different kinds and those furnished at different times. The value of a furnished fringe benefit is fair market value as determined in arm's length transactions, although regulations may set forth formulary approaches to simplify valuation. In many cases the regulations may permit the use of the employer's out of pocket cost as the tax base.

In a country where it is probable that fringe benefits will not constitute a major problem, consideration can be given to placing this tax on a quarterly rather than a monthly basis.

Under section 161(a) the general rate for the fringe benefit tax is 30%. The 30% tax is applied to the net fringe benefit plus the tax on the worker that is in effect provided by the employer. Thus for a 30% rate of individual tax (on the worker), the net benefit is divided by 0.7 to arrive at the tax base. For workers at a lower marginal individual rate, it would be appropriate to have a different reciprocal divisor. However, we have kept a uniform gross up based upon an assumed 30% individual rate for simplicity of computation. If that makes fringe benefits a slightly more costly way of paying compensation as opposed to cash, we do not regard that as undesirable. The fringe benefit tax is deductible by the payor as compensation would be, if the payment of the underlying fringe benefit meets the conditions for deductibility of business expense.

Parenthetically it should be noted that it is important that the base for payroll tax to fund social insurance contributions should include the grossed up base for the fringe benefit tax. Otherwise there will still be a strong incentive to substitute fringe benefits for cash to avoid a high payroll tax. In countries that maintain individual accounts of payroll taxes that are credited for computing benefits for those individuals, the fringe benefit base may not be capable of allocation to individuals. That should not exempt it from the payroll tax, however, but it may provide employees a further incentive to receiving cash compensation to increase their pension credits.

Under Section 32(b) deductions for entertainment expenses are disallowed. Wholly apart from the disallowance of entertainment expenses as business expenses of the employer, frequently the providing of the disallowed entertainment will include expenditures on behalf of one or more employees. Notwithstanding the disallowance of deductions for the entertainment expenses, the portion attributable to the employee constitutes a fringe benefit to the employee and is subject to the fringe benefit tax. In that case the entertainment part of the expense would be disallowed under Section 32(b), but the fringe benefit tax itself would be deductible.

In a country with a rate scale substantially more graduated than the BWTC, and especially where the entity and top personal rates varied considerably, substantial refinement of our fringe benefit tax might be called for. In such a situation a country might still find a fringe benefit tax attractive, but limit its application to benefits most difficult to value or to assign individually. For benefits easier to attribute to particular individuals, it may be acceptable to include the benefits in income and to rely on withholding taxes, with substantial penalties for failure by employers to withhold.

Sec. 162. Fringe Benefit Defined.

Section 162 defines "fringe benefit" for application of the special tax under Section 161. Ordinarily this means a benefit furnished in kind, but it may also include a benefit paid in cash (such as cash paid by the employer to a life insurance or health provider) so long as the benefit is not of the kind for which withholding is required under Section 171.

To be within the definition the benefit must include a substantial personal element and (except in the case of entertainment and similar expenses) must be furnished to the individual in relation to the performance of services. A benefit furnished by an employer to an individual is in consideration of services under Section 162 if the benefit would not have been furnished if the recipient had never been employed by the payor or a party related to the payor. Thus, the payment of a sum on retirement or some other special occasion to an employee cannot be treated as a nontaxable gift except in the most unusual cases. For example, there can be a genuine gift from a parent to a child who also incidentally happens to be an employee. In no case can a payment claimed to be a gift be deducted as a business expense by the payor.

Section 162(b) specifies certain items providing a substantial personal benefit to the service performer that are included as fringe benefits and hence subject to the special tax on the payor. A fringe benefit includes only that which the employer furnishes. An employee who directs that a portion of his or her cash compensation be used by the employer to purchase a benefit for the employee from an independent third person at market value shall be deemed to have been paid in cash subject to withholding and not to have received a fringe benefit from the employer. An example is insurance premiums on an individual policy for the employee paid at the employee's direction. The list of fringe benefits includes vehicles, food, housing, below market interest loans, insurance premiums, and expense allowances to the extent not substantiated as used for the employer's deductible business expenses. To the extent an expense allowance is not substantiated as for deductible business expenses of the employer, it is not only subject to the fringe benefit tax but it is not deductible by the employer under Section 31(a). The failure to include an item on the list does not preclude its classification as a fringe benefit since the list is nonexclusive.

Section 162(c) excludes pension contributions excludable from the Section 1 tax under Section 121 or 122. It also excludes cash payments of the kind ordinarily treated as compensation for services and subject to withholding.

Sec. 163. Interest Paid to Domestic Individuals by Domestic Financial Institutions.

Section 163 imposes a special tax on interest paid by a domestic financial institution to a domestic individual of 5% of the gross amount. This special tax is in lieu of the regular individual income tax. For this purpose interest taxable to an individual as his or her share of income of a pass-through is treated as received by the individual, as the pass-through is disregarded as a taxable entity.

The special tax is designed for the rather common situation where bank accounts, particularly for small savers, pay either low interest (in real inflation adjusted terms), or even negative real interest. High income taxpayers would rarely invest their funds in such deposits. Where it is desirable to have a largely return free society with wage withholding equal to final liability in the overwhelming percentage of cases, a country would not want to precipitate a large number of returns because of small amounts of interest. Hence this low rate final tax. Where bank accounts are substantially attractive as recipients of funds, this provision should be dropped, or limited, if it is possible, to a particular type of account that is not attractive to high income taxpayers, and that can be readily distinguished by banks, to make withholding easily administered.

Sec. 164. Advance Tax on Dividend Distributions.

Section 164 provides dividend relief through a credit against entity tax for withholding on dividends paid to shareholders of entities. The rate of withholding is 30% of the gross dividend, i.e., before withholding. To calculate the gross dividend, divide the actual payment by .7. Thus every amount paid as a dividend is deemed to be a dividend of the amount actually paid grossed up for the 30% withholding tax. An actual payment of PR 70 is deemed to have been a dividend of PR 100 from which PR 30 has been withheld. The deemed withheld amount is paid as tax to the government, but the amount is credited against the payor's entity tax liability. Thus, the entity tax is really an advance payment of the tax upon the shareholder on earnings received through entity ownership. A payor includes a branch of a foreign entity treated separately under Section 12(e) that remits earnings from Progresa. Excess credits for deemed withholding in any year that exceed corporate tax liability will be paid as withheld tax but will carry forward to offset succeeding years' entity tax liability until used. The entire tax liability of the Progresa shareholder recipient is satisfied by the deemed withholding. Thus, as to distributed entity income only one tax of 30% is paid.

In the case of a distribution from one entity to a 20% or more owner, the same deemed withholding applies to the actual dividend payment, and the distributor receives the credit for withholding against the distributor's entity tax. The recipient entity does not include the dividend in income, but sets up an account for the net dividend. Amounts of dividends received by a 20% owner thus are accounted for separately and may be distributed free of withholding to individual owners, since there has been withholding at the entity level by the first distributor.

Section 164(e) provides that an individual or entity receiving a dividend will not include the dividend in income. In some of the countries we have visited there has been resistance to a complete exclusion at the shareholder level. Instead a preference has been stated for taxing the shareholder on dividends to the same extent as wages are taxed, or to taxing the shareholders in part either through a credit of part of the entity tax or through the imposition of a less than full rate — perhaps a rate of 15% or 20%. Certainly there are ample precedents for these alternatives in the income tax laws of developed countries.

The ideal method to integrate the entity and shareholder taxes is to attribute to each shareholder a proportionate share of the entity income, to require the shareholder to report that share on the shareholder's tax return, and to allow the shareholder a credit for the shareholder's proportionate share of the entity's prepaid tax. (There will be difficulty in calculating proportionate shares of income and credit where the shareholder acquires or disposes of equity shares during the entity's taxable year). If the shareholder's credit exceeds the tax, the difference would be refunded. We have chosen our imperfect alternative to avoid such complexity. One of the prices for such simplification is a measure of double taxation. To the extent a shareholder realizes taxable gain on a sale of shares that is attributable to retained already taxed earnings, there may be a double tax. Further if an entity does not distribute currently all its earnings and thus offset all its entity tax liability, it may find in some later year that it is making distributions and generating withholding credits that it cannot use (since there is no carry back of excess credits). Further if an entity distributes dividends from foreign source income that is not subject to entity tax, the withholding tax can undo the foreign source exemption. To avoid this problem requires a separate tracing of dividends from foreign source income. We have not provided for this at this time, since Progresa entities are not likely for the immediate future to have significant income from foreign sources.

It might be possible to provide the full integration discussed above for entities with a small number of shareholders, say up to 10 individuals. In such case a simplified form of integration modeled after the U.S. subchapter S could be enacted.

Countries that enact a second low rate final tax (for example, 15%) on distributed income should allow a refund of the second tax to tax exempt organizations. They should also have a branch profits tax on entities operating in unincorporated form in their country. The branch profits tax should be somewhere between 0 and the full 15% to reflect the average level of repatriated dividends. It is administratively difficult to construct a hypothetical calculation of remissions that are dividends where we are dealing with transfers of funds within one legal entity.

Chapter 13. Withholding Taxes and Advance Payments of Tax.

Chapter 13 provides for withholding taxes and advance payments for tax.

Sec. 171. Wage Withholding.

Section 171(a) requires every resident payor to withhold from wages a tax determined under Section 171.

The rate of withholding is set at 30% (the top rate under Section 3 for individuals) unless the payor has been designated as the employee's principal employer. In that case, the rate of withholding will be determined under tables.

There will be withholding for each payroll period. This is defined in Section 171(f) as the period for which the employer usually pays wages to the employee.

Wage withholding is the cornerstone of a successful tax on the income of individuals. The withholding system embodied in Section 171 will eliminate the need for most individuals to file income tax returns, while combining compensation income in a true global base for those who may have other income (such as from business, rent, royalties, and the sale of property).

The amount to be withheld by a principal employer will be determined from tables published for each payroll period (whether daily, weekly, monthly, or otherwise). In order to show how such a table is constructed, we have presented a monthly payroll table. The amount of wages falling in each withholding rate bracket (including the zero bracket) is determined for the first payroll period in the calendar year by dividing the annual bracket amounts set forth in Section 3 by 12 (the number of monthly payroll periods in the calendar year). In order to keep the total withheld at any time during the year in line both with changes in the employee's rate of compensation and with any inflation adjustments required under Section 79, the table is constructed by adding another tier of monthly bracket amounts to the bracket amounts established for the immediately preceding payroll period.

Under Section 171(e) the employee may have only one principal employer at a time. Any other employer is required to withhold at the maximum 30% rate.

Section 171(g) defines "wages" to include wages, salaries, and bonuses, and any other compensation to which regulations extend Section 171 withholding.

Section 171(h), however, provides that there will be no withholding on items that are not part of includible income, whether by reason of the exclusions under Section 13(c), or by reason of the fact that they are not treated as Progresa-source income.

Section 171(i) defines "resident payor" to include resident entities, resident pass-throughs, permanent establishments (as defined in Section 12(e)), governmental units and nonprofit organizations, and resident individuals with respect to compensation paid to the employees of a business.

Section 171(j)(1) subjects to withholding the compensation of officers of the government and officers and directors of entities.

Section 171(j)(2) authorizes regulations extending wage withholding to individuals not called employees but who have at least two of the significant characteristics of employees. An employee is not usually at risk of lack of payment for the services. An employee is not usually able to fix the time and place for the services. An employee is not usually required to have a significant investment in the equipment necessary to perform the services. An employee does not usually provide services to several recipients simultaneously. That a person is a temporary worker does not make that person any the less an employee, however.

Section 171(k) sets up a system of withholding as a final tax, without necessity of a return. Some countries may wish to tax a greater proportion of the individuals under the income tax than we recommend. They may be unable to impose consumption taxes at the level necessary to finance government, but can achieve the necessary level of revenue production by subjecting a large body of wage earners to an income tax. Most of such workers will have no income other than wage income (or interest of the nature taxed under Section 163). Thus, if the proper withholding is achieved, there is no need for a return by the employee, and the withholding can be a final tax. The payor would be required, however, to report the taxpayer identification number and amount of withholding to the Tax Administrator. A taxpayer could elect out of finality of the tax if there were reasons to do so (such as over withholding because the taxpayer had charitable deductions). The withholding would reflect the zero bracket amount of Section 3(a). An employee who worked for more than one employer simultaneously would have the zero bracket amount and 15% rate reflected in withholding only by the primary employer. An employee who changes jobs would carry with him or her evidence from the prior employer showing the wages paid and tax withheld by all prior principal employers during the year.

Sec. 172. Withholding on Interest, Royalties, and Gambling Winnings.

Section 172 requires withholding on payments by resident payors of interest, royalties, and gambling winnings.

Under Section 172(c) the withholding rates are:

(1) 5% for interest paid to resident individuals by resident financial institutions,

(2) 15% on other interest,

(3) 15% on royalties (whether for intangibles such as patents, copyrights, or know-how or for interests in minerals or oil and gas), and

(4) 30% on gambling winnings.

Sec. 173. Withholding on Transfers of Interests in Progresa Real Property.

Section 173 authorizes regulations to extend withholding to payments for the transfers of land and buildings situated in Progresa or of interests in such property. The amount would be the lesser of 15% of the payment (grossed up to take account of the withholding) or 30% of the transferor's gain. Regulations would deal with the procedures for the use by the purchaser of the seller's certification of the amount of gain realized on the transfer, and would also deal with other matters such as installment payments.

Sec. 174. Withholding on Payments to Nonresident Persons.

Section 174 contains the general requirement that resident payors are to withhold 15% of the grossed up amount of any payment they make to a nonresident entity or nonresident individual. However, this requirement does not apply to any payment for which withholding is required by Section 171 (wages), 172 (interest, royalties, and gambling winnings), or 173 (transfers of Progresa real property).

Under Section 174(c) the Section 174 tax will constitute a final tax for the nonresident entity or individual.

Sec. 175. Advance Payment of Income Tax.

Section 175 provides a system of tax payments for individuals and entities for income not covered by withholding. The tax payments are based on the previous year's tax and are paid 50% on June 30, 30% on September 30, and 20% on December 31. Amounts paid are credits against tax liability. A taxpayer may demonstrate that his or her income is at least 30% lower than the preceding year and obtain relief in the form of reduced payments. Insufficient payments are subject to interest payable with the final tax return.

Some countries may prefer a different system of advance payments. For example, they may establish a system with equal quarterly payments based on anticipated income for the current year. The system could provide a margin for error in which no penalties and interest would be charged.

Chapter 14. Credits.

Sec. 181. Credits Against Tax.

Chapter 14 and Section 181 provide for credits for withheld tax, advance tax payments, and the foreign tax credit (with respect to investment and financial income from foreign sources of a resident taxpayer).

Sec. 182. Credit for Foreign Tax on Investment and Financial Income.

The only income subject to taxation that is from sources outside Progresa is that from investment or financial income of resident taxpayers. Section 182 provides a credit against Progresa tax liability on such income for foreign taxes paid on the same income. The credit is subject to a per country limit so that credit will be allowed only to the extent that the foreign rate of tax does not exceed Progresa's effective rate of tax on the taxpayer's taxable income. A distribution from a 10% or more owned operating subsidiary to a Progresa entity is not financial or investment income, but rather treated the same as if the Progresa entity operated abroad as a branch. Hence, such distributions, if derived from earnings sourced outside Progresa (unless within the personal holding entity provisions of Section 136), are income derived from sources outside Progresa and non-taxable.